

This record is a partial extract of the original cable. The full text of the original cable is not available.

UNCLAS SECTION 01 OF 05 THE HAGUE 002750

SIPDIS

STATE FOR EUR/UBI SHERRI HOLLIDAY

USDOC FOR 4212/USFCS/MAC/QEURA/FALCO
TREASURY FOR IMI/OASIA/VIMAL ATUKARALA
PARIS ALSO FOR OECD
FRANKFURT FOR TREASURY/WALLAR
STATE PASS FEDERAL RESERVE FOR MICHAEL ACCORNERO

E.O. 12356: N/A

TAGS: [ECON](#) [EFIN](#) [PREL](#) [EINV](#) [ELAB](#) [PGOV](#) [MCAP](#) [NL](#)

SUBJECT: DUTCH 2004 BUDGET: TOUGH DEFICIT REDUCTION PACKAGE
KEEPS DEFICIT WITHIN STABILITY PACT CRITERIA

REF: THE HAGUE 1697

SUMMARY

1. THE DUTCH PARLIAMENT HAS APPROVED A TOUGH DEFICIT REDUCTION PACKAGE AIMED AT LIMITING THE 2004 BUDGET DEFICIT TO 2.3 PERCENT OF GDP, WELL UNDER THE THREE PERCENT STABILITY AND GROWTH PACT (SGP) CEILING. ON OCTOBER 1, THE PARLIAMENT APPROVED A CY 2004 BUDGET THAT COMBINES SHARP SPENDING REDUCTIONS WITH CUTS IN TRANSFER PAYMENTS INTO AN UNPRECEDENTED PACKAGE OF RETRENCHMENTS WORTH 16.7 BILLION EURO (ROUGHLY \$ 19 BILLION) OVER FOUR YEARS. THE TIGHT 2004 BUDGET IS A RESPONSE TO THE MOST DISAPPOINTING ECONOMIC PERFORMANCE IN A DECADE, WHICH WOULD HAVE DRIVEN NEXT YEAR'S DEFICIT TO 3.8 PERCENT OF GDP IN THE ABSENCE OF CORRECTIVE MEASURES.

2. THE GOVERNMENT HAS SO FAR SUCCESSFULLY DEFENDED THESE BUDGET PLANS AS NECESSARY TO REMAIN WITHIN SGP LIMITS, PROMOTE COMPETITIVENESS, TRIM THE DUTCH WELFARE STATE, AND INCREASE WORK INCENTIVES. IN DOING SO, IT IS FACING THE IRE OF MANY PROMINENT ECONOMISTS WHO ARGUE AGAINST FISCAL RETRENCHMENT DURING A RECESSION AND THE LEFT-WING OPPOSITION PARTIES AND LABOR UNIONS WHO WANT TO PRESERVE WELFARE STATE BENEFITS. THE GONL, WARY OF RUNNING UP DEBT IN VIEW OF THE AGING DUTCH POPULATION, BELIEVES THAT DEMAND STIMULUS IN A SMALL OPEN ECONOMY SUCH AS THE NETHERLANDS' IS INEFFECTIVE. THE DEBATE OVER THIS BUDGET IS LIKELY TO BE REPEATED IN SUBSEQUENT YEARS, AS WITHOUT ADDITIONAL DEFICIT-REDUCTION MEASURES, THE FISCAL DEFICIT WILL CONTINUE TO BUMP UP AGAINST THE SGP'S 3 PERCENT DEFICIT CRITERION. THIS WILL BE A TEST FOR FINANCE MINISTER ZALM, WHO HAS STAKED MUCH OF HIS INTERNATIONAL REPUTATION ON PROMOTING STRICT ADEHERENCE TO SGP CRITERIA (REFTEL). END SUMMARY.

A BUDGET GRAPPLING WITH FISCAL STABILITY

3. AMIDST ECONOMIC RECESSION AND RESULTING REVENUE SHORTFALLS, THE CENTER-RIGHT COALITION GOVERNMENT PRESENTED THE DRAFT 2004 BUDGET TO PARLIAMENT SEPTEMBER 16. FOLLOWING POLITICAL AND FINANCIAL DEBATES THE LOWER HOUSE AGREED TO THE OVERALL BUDGET PARAMETERS WITH ONLY MINOR AMENDMENTS OCTOBER 1. PARLIAMENTARY DEBATE ON THE PARTICULAR ELEMENTS OF EACH MINISTRY'S BUDGET WILL CONTINUE THROUGH NOVEMBER BUT THE OVERALL BUDGET AND ITS ALLOCATION AMONG MINISTRIES IS NOW FIXED. DURING CY 2004, MINISTRIES MAY BE ABLE TO REPROGRAM FUNDS WITHIN THEIR INDIVIDUAL BUDGET ALLOCATIONS BUT A TRANSFER OF FUNDS BETWEEN ONE MINISTRY AND ANOTHER IS NOT FEASIBLE. DUE CHIEFLY TO STAGNATING ECONOMIC GROWTH AND FALLING REVENUES, PUBLIC FINANCES HAVE COME UNDER PRESSURE, PUTTING THE BUDGET ON A PATH TO OVERSHOOT THE EMU'S GROWTH AND STABILITY PACT (GSP) DEFICIT AND DEBT CRITERIA WITHOUT FISCAL RETRENCHMENT. ACCORDING TO THE NEW BUDGET, WHICH IS BASED ON PROJECTED 2004 GROWTH OF TWO PERCENT AND CONTINUED RESTRAINT IN PUBLIC SECTOR WAGES, CENTRAL GOVERNMENT SPENDING WILL RISE SLIGHTLY (LESS THAN THREE PERCENT) TO 118.8 BILLION EURO (\$136.6 BILLION) IN 2004, WITH REVENUES TOTALING 106.5 BILLION EURO (\$122.5 BILLION), RESULTING IN A BASIC BUDGET DEFICIT OF 12.3 BILLION EURO (\$14.1 BILLION), OR 2.6 PERCENT OF GDP. WITH TOTAL SPENDING OF 134.4 BILLION EURO (\$154.6 BILLION) AND REVENUES OF 123.7 BILLION EURO (\$142.2 BILLION), THE PUBLIC SECTOR BALANCE FOR EMU PURPOSES (CENTRAL GOVERNMENT, LOCAL GOVERNMENT AND SOCIAL SECURITY FUNDS BUDGETS COMBINED) WILL BE MOVING INTO A DEFICIT OF 10.7 BILLION EURO (\$ 12.3 BILLION), OR 2.3 PERCENT OF GDP. THIS COMPARES WITH A SIMILAR DEFICIT OF 2.3 PERCENT OF GDP PROJECTED FOR 2003 AND FOLLOWS THE SURPLUS OF 2.2 PERCENT RECORDED IN 2000.

TABLE 1: THE 2004 BUDGET (EUR BN)

CENTRAL GOVT:
--SPENDING 118.8

--REVENUE	106.5
--DEFICIT	12.3
PUBLIC SECTOR:	
--SPENDING	134.4
--REVENUE	123.7
--DEFICIT	10.7

A CHOICE BETWEEN GROWTH AND FISCAL STABILITY

14. TO PREVENT THE DEFICIT IN 2004 FROM EXCEEDING THE 3 PERCENT DEFICIT CRITERION IN THE SGP, THE 2004 BUDGET SUPPLEMENTS A 5.2 BILLION EURO CONSOLIDATION PACKAGE INHERITED FROM THE PREVIOUS "BALKENENDE I" GOVERNMENT (THAT FELL IN EARLY 2003) WITH ADDITIONAL BUDGET MEASURES TO THE TUNE OF 5.7 BILLION EURO. SUPPLEMENTAL RETRENCHMENTS RAISE TOTAL SPENDING CUTS AND BURDEN INCREASES (I.E., INCREASES IN TAXES AND FEES AND REDUCTIONS IN SUBSIDIES) IN 2004 TO 10.9 BILLION EURO (\$ 12.5 BILLION). ROUGHLY HALF OF THE PACKAGE IS AIMED AT IMPROVING MARKET FUNCTIONING AT THE MICRO LEVEL (E.G., FOR HIGHER LABOR MARKET PARTICIPATION THROUGH TIGHTER ENFORCEMENT OF DISABILITY BENEFIT RULES). THE OTHER HALF (E.G., LOWER SPENDING ON ASYLUM PROGRAMS, ON DEVELOPMENT AID, ON SUBSIDIES TO NGO'S, AND ON A HOST OF CARE PROGRAMS) CONSISTS OF STRAIGHTFORWARD MONEY-SAVING MEASURES THAT REFLECT THE COALITION'S DETERMINATION TO STRICTLY ADHERE TO THE SGP DEFICIT AND DEBT CRITERIA AND TO REDUCE THE SIZE AND SCOPE OF GOVERNMENT. THE BULK OF THESE MEASURES BEAR THE UNMISTAKEN SIGNATURE OF FINANCE MINISTER ZALM'S LIBERAL PARTY (VVD), THE MOST LIMITED-GOVERNMENT-ORIENTED PARTNER IN THE CENTER-RIGHT COALITION.

15. BY FAR THE LARGEST PORTION OF THE PACKAGE OF SPENDING CUTS (3.1 BILLION EURO (\$3.6 BILLION)) WILL BE IN MAJOR SOCIAL SECURITY PROGRAMS (LABOR DISABILITY AND UNEMPLOYMENT BENEFITS) WITH THE OBJECTIVE OF CREATING INCENTIVES FOR HIGHER LABOR MARKET PARTICIPATION. THE REMAINING SAVINGS WILL COME FROM FREEZING OF PUBLIC SECTOR WAGES AND PAY CONDITIONS TO THE TUNE OF 1.3 BILLION EURO, A REDUCTION OF PUBLIC SECTOR RED-TAPE OF 1 BILLION EURO, REDUCED FINANCING OF NON-ODA ITEMS AND AID TO ASYLUM SEEKERS OF 800 MILLION EURO, CURTAILING SEVERAL PUBLIC SUBSIDY PROGRAMS BY 1.9 BILLION EURO, REDUCING HEALTH CARE SUBSIDIES BY 1.7 BILLION EURO, AND BY CURTAILING VARIOUS OTHER TAX INCENTIVES AND SUBSIDIES BY 1.2 BILLION EURO. DURING THE COALITION'S FOUR-YEAR TERM IN OFFICE, THE ACCUMULATED CONSOLIDATION PACKAGE OF MEASURES WILL ADD UP TO 22.9 BILLION EURO, EQUAL TO FOUR PERCENT OF GDP. THE GOVERNMENT PROJECTS THAT ITS MEASURES WILL REDUCE THE CONSOLIDATED PUBLIC SECTOR DEFICIT FOR EMU PURPOSES TO A PROJECTED 0.6 PERCENT OF GDP IN 2007, LOWERING THE PUBLIC DEBT TO GDP RATIO IN THAT YEAR TO A LITTLE OVER 52 PERCENT.

RAISING REVENUES AT THE EXPENSE OF TAX PAYERS

16. IN THE WAKE OF BUDGET RETRENCHMENTS THE 2004 BUDGET ALSO PROVIDES FOR MEASURES TO RAISE REVENUES AMOUNTING TO AN ESTIMATED 1.2 BILLION EURO, GROWING AN TO ACCUMULATED 1.9 BILLION EURO IN 2007. THE HIGHER TAX BURDEN IN FISCAL YEAR 2004 IS THE BALANCE OF MEASURES AIMED AT RAISING TAX REVENUES ON THE ONE HAND AND THE INTRODUCTION OF TAX INCENTIVES AIMED AT STIMULATING THE COALITION'S LABOR MARKET POLICIES ON THE OTHER. WIDENING THE GENERAL INCOME TAX BASE, ABOLISHING TAX INCENTIVES FOR EARLY RETIREMENT, AND CURTAILING THE DEDUCTIBILITY OF MORTGAGE INTEREST WILL RAISE REVENUES BY 500 MILLION EURO (OR A CUMULATIVE 4.1 BILLION EURO FOR 2004-2007). REALLOCATING SPENDING ON HEALTH CARE AND RAISING THE EXCISE TAX ON TOBACCO WILL RAISE REVENUES BY 1 BILLION EURO (AN ACCUMULATED BALANCE OF 200 MILLION). INCREASING THE NUMBER OF TAX INCENTIVES CONTRIBUTING TO LABOR MARKET DYNAMICS AND IMPROVEMENT OF EDUCATION AND COMPENSATING FOR THE IMPACT OF HIGHER TAXES AND REDUCED SPENDING ON INCOMES OF VULNERABLE INCOME CATEGORIES WILL REDUCE REVENUES BY 300 MILLION EURO, OR A CUMULATIVE FOUR-YEAR TOTAL OF 2.1 BILLION EURO.

LITTLE MONEY LEFT FOR NEW POLICY SPENDING

17. THE COALITION HAS EARMARKED A RELATIVELY SPARTAN 3.9 BILLION EURO IN 2004, GROWING TO AN ACCUMULATED 8.1 BILLION EURO IN 2007, ON NEW POLICY SPENDING. THE BULK WILL GO TO FINANCE MEASURES AIMED AT CONTROLLING COST IN PUBLIC HEALTH INSURANCE, REMOVING STRUCTURAL BOTTLENECKS (CAPACITY AND STAFFING) IN HEALTH CARE, AND STIMULATING DEREGULATION AND PRIVATIZATION IN HEALTH CARE (1.3 BILLION EURO). ROUGHLY 1.2 BILLION EURO WILL GO TO FINANCE LABOR MARKET MEASURES INTENDED TO BOOST EMPLOYMENT AND RAISE LABOR MARKET PARTICIPATION BY REDUCING CLAIMS IN UNEMPLOYMENT AND LABOR DISABILITY BENEFITS. THE REMAINING 1.5 BILLION EURO WILL GO TO PAY FOR IMPROVEMENT OF THE KNOWLEDGE INFRASTRUCTURE AND THE QUALITY OF R&D (0.5 BILLION), A REDUCTION IN OVERALL CRIMINALITY BY IMPROVING THE LAW ENFORCEMENT CHAIN AND BY MORE AGGRESSIVELY TACKLING YOUTH CRIMINALITY (0.5 BILLION), AND IMPROVING MOBILITY BY UPGRADING THE TRANSPORT

INFRASTRUCTURE (0.5 BILLION).

DEFENSE AND DEVELOPMENT AID BUDGETS RELATIVELY UNHURT

18. DEFENSE WILL GET AN EXTRA 30 MILLION EURO (\$34.5 MILLION) (GROWING TO 100 MILLION EURO EQ \$ 115 MILLION IN 2007) TO FINANCE MEASURES TO STRENGTHEN THE DEPLOYMENT OF DUTCH ARMED FORCES IN OPERATIONS RELATED TO CONTAINMENT OF REGIONAL CRISES. EXTRA DEFENSE OUTLAYS WILL ONLY PARTLY COMPENSATE FOR A 215 MILLION EURO (\$ 247 MILLION) REDUCTION (OR A CUMULATIVE 350 MILLION EURO FOR 2004-07) THAT IS INTENDED TO RESULT IN DOWNSIZED BUT MORE EFFECTIVELY DEPLOYABLE ARMED FORCES. INCLUDING SAVINGS ALREADY PROVIDED FOR IN THE GOVERNMENT'S COALITION ACCORD, TOTAL CUTS IN DEFENSE SPENDING WILL AMOUNT TO 470 MILLION EURO EQ \$ 540 MILLION IN 2004, AND TO ACCUMULATED 730 MILLION EURO EQ \$840 MILLION IN 2007. ON BALANCE, DEFENSE SPENDING IN 2004 WILL STILL SHOW AN INCREASE OF 3 PERCENT TO 1.6 PERCENT OF GDP. ALTHOUGH SUBJECT TO GEOGRAPHIC AND THEMATIC RELOCATION, THE SPENDING TO GDP RATIO FOR OFFICIAL DEVELOPMENT ASSISTANCE (ODA) CONTINUES AT A HIGH OF 0.8 PERCENT OF GDP

ADHERING TO THE STABILITY PACT IN A CYCLICAL DOWNTURN

19. UNFAVORABLE CYCLICAL DEVELOPMENTS AND POOR PERFORMANCE OF THE DUTCH ECONOMY SINCE 2001 HAVE GIVEN RISE TO A DRAMATIC DETERIORATION OF PUBLIC FINANCES. AFTER MOVING INTO THE FIRST SMALL (0.7 PERCENT OF GDP) FISCAL SURPLUS IN DECADES IN 1999, THE FISCAL BALANCE MOVED BACK INTO A 1.6 PERCENT DEFICIT IN 2002. DUE TO THE LOSS OF TAX REVENUES AND GROWING SPENDING ON SOCIAL SECURITY AND UNEMPLOYMENT RESULTING FROM THE SLUGGISH ECONOMY, THE PROJECTED FISCAL DEFICITS FOR 2004 AND 2005 WOULD HAVE OVERSHOT THE SGP'S 3 PERCENT DEFICIT CRITERION IN THE ABSENCE OF DEFICIT-REDUCTION MEASURES, WITH THE BASELINE 2004 DEFICIT PROJECTED AT 3.8 PERCENT OF GDP. WITH ITS FOUR-YEAR, 16.9 BILLION EURO PACKAGE, THE THE CENTER-RIGHT COALITION EXPECTS THE PUBLIC SECTOR DEFICIT TO FALL FROM 2.3 PERCENT OF GDP IN 2004 TO 0.6 PERCENT BY 2007. SHOULD THE DEFICIT BROACH A SELF-IMPOSED CEILING OF 2.5 PERCENT OF GDP DURING THAT PERIOD, ADDITIONAL BUDGET RETRENCHMENTS WILL BE TRIGGERED. OVER THE SAME 2004-07 PERIOD, THE CYCLICALLY-ADJUSTED STRUCTURAL DEFICIT WILL DECLINE SLIGHTLY, FROM 0.7 PERCENT IN 2004 TO 0.5 PERCENT IN 2007.

110. AS A RESULT OF SUCCESSIVE FISCAL DEFICITS, THE PUBLIC DEBT TO GDP RATIO, WHICH HAS FALLEN ANNUALLY SINCE 1995, WILL GROW TO 54.0 PERCENT OF GDP IN 2003 AND A PROJECTED 54.5 PERCENT IN 2004. THE GONL PROJECTS THAT ITS DEFICIT-REDUCTION PROGRAM AND A REVIVAL IN GROWTH WILL CUT THE RATIO TO 52.2 PERCENT OF GDP IN 2007.

NEAR-TERM ECONOMIC OUTLOOK: CAUTIOUS

111. THE DRAFT 2004 BUDGET WAS PRESENTED AT A TIME WHEN THE DUTCH ECONOMY IS SLOWLY RECOVERING FROM THE LONGEST AND DEEPEST RECESSION IT HAS SEEN SINCE THE EARLY 1990S. FOLLOWING GDP GROWTH OF JUST 0.2 PERCENT IN 2002, THE ECONOMY SLUMPED INTO (DOWNWARD REVISED) AVERAGE 0.7 PERCENT NEGATIVE GROWTH DURING THE FIRST HALF OF 2003. IN THE CURRENT CLIMATE OF SHARPLY LOWER PUBLIC SPENDING, EXPORTS WILL BECOME AN IMPORTANT DETERMINANT OF ECONOMIC EXPANSION. A RAPID RECOVERY OF ECONOMIC GROWTH IS NOT IMMINENT, HOWEVER, AS A SERIOUS LOSS OF PRICE COMPETITIVENESS WILL KEEP THE ECONOMY FROM FULLY BENEFITTING FROM A RECOVERY OF WORLD TRADE GROWTH DURING THE SECOND HALF OF 2003. LAGGING BEHIND WORLD TRADE GROWTH, EXPORTS ARE FORECAST TO EXPAND BY 1 PERCENT IN 2003, FOLLOWED BY 5.25 PERCENT IN 2004. EXPORT GROWTH WILL BE GENERATED PREDOMINANTLY BY AN INCREASE IN THE VOLUME OF RE-EXPORTS (UP 4 PERCENT AND 8.5 PERCENT IN 2003 AND 2004 RESPECTIVELY). GROWTH IN DOMESTICALLY PRODUCED EXPORTS IS EXPECTED TO REMAIN STAGNANT (MINUS 1.5 PERCENT IN 2003 AND PLUS 2.75 PERCENT IN 2004). THE MODEST RECOVERY OF FOREIGN DEMAND WILL NOT BE SUFFICIENT TO COMPENSATE FOR WEAKER CONSUMER SPENDING AND FALLING INVESTMENT. LOSS OF PURCHASING POWER, SLUMPING STOCK MARKETS AND GROWING UNEMPLOYMENT WILL KEEP CONSUMER SPENDING MORE OR LESS DORMANT (ZERO GROWTH FOLLOWED BY 0.75 EXPANSION IN 2003 AND 2004 RESPECTIVELY), WHILE SURPLUS CAPACITY, ERODING MARGINS AND POOR PRODUCER CONFIDENCE WILL PUT A DAMPER ON NON-RESIDENTIAL INVESTMENT (MINUS 3.75 PERCENT AND MINUS 0.75 PERCENT IN 2003 AND 2004 RESPECTIVELY). IN A CLIMATE OF RELATIVELY WEAK DOMESTIC AND FOREIGN DEMAND, THE DUTCH ECONOMY CONTINUES TO PERFORM WELL BELOW ITS 2.5 PERCENT GROWTH POTENTIAL TO SHOW ZERO GROWTH IN 2003 AND JUST ONE PERCENT GDP EXPANSION IN 2004. IN THE ABSENCE OF CLEAR SIGNS OF IMPROVEMENTS, EVEN THESE MODEST GROWTH EXPECTATIONS MAY PROVE TOO AMBITIOUS AND ERODE THE ECONOMIC BASIS OF THE 2004 BUDGET.

112. REFLECTING THE ECONOMIC DOWNTURN, THE OUTLOOK FOR THE LABOR MARKET HAS CHANGED DRAMATICALLY. FOR THE FIRST TIME IN EIGHT YEARS NEGATIVE EMPLOYMENT GROWTH, COMBINED WITH A

GROWING NUMBER OF REDUNDANCIES, HAS PUSHED THE LEVEL OF UNEMPLOYMENT WELL BEYOND ITS EQUILIBRIUM. AS A CONSEQUENCE UNEMPLOYMENT IS FORECAST TO INCREASE TO A LEVEL OF 5.5 PERCENT OF THE LABOR FORCE IN 2003 AND TO FURTHER EXPAND TO 7 PERCENT OF THE LABOR FORCE IN 2004. THE RESULTING HIKE IN UNEMPLOYMENT BENEFITS IS AMONG THE FACTORS CONTRIBUTING TO THE UNEXPECTED PUBLIC SPENDING INCREASE.

13. WITH CONSUMER PRICE INFLATION COMING DOWN TO 2 PERCENT IN 2003 AND TO 1.5 PERCENT IN 2004, INFLATION THUS SEEMS THE ONLY POSITIVE NOTE LINING ON AN OTHERWISE CLOUDY PICTURE. AN INCREASE IN INDIRECT TAXES (HIGHER TOBACCO EXCISE AND ROAD TAXES) AND BUSINESS SECTOR ATTEMPTS TO REPAIR ERODED GROSS MARGINS BY INCREASING PRICES WILL PUT SOME UPWARD PRESSURE ON CONSUMER PRICE INFLATION. IMPORTED INFLATION ON THE OTHER HAND HAS EASED DUE TO THE STRENGTH OF THE EURO VIS-A-VIS THE DOLLAR. SIMILARLY A COMBINATION OF MODERATE WAGE DEVELOPMENTS AND ACCELERATING LABOR PRODUCTIVITY GROWTH HAS SOFTENED THE IMPACT OF PER UNIT LABOR COSTS ON CONSUMER PRICE INFLATION.

MOTIVATIONS AND REACTIONS: ECONOMISTS CRITICAL

14. IN A FIRST REACTION TO THE DRAFT 2004 BUDGET, THE GOVERNMENT'S HIGHEST ADVISORY BODY, COUNCIL OF STATE (AN OFFICIAL PANEL OF EMINENT PERSONS CHARTERED TO ADVISE THE GOVERNMENT), AND A GROWING NUMBER OF ECONOMISTS HAVE CRITICIZED THE MAGNITUDE AND THE TIMING OF THE PACKAGE OF RETRENCHMENTS AND BURDEN INCREASES AS UNFORTUNATE. MANY ECONOMISTS ARGUE THAT NEITHER THE GOVERNMENT'S CURRENT FISCAL PROBLEMS NOR ITS DETERMINATION TO COMPLY WITH THE EMU STABILITY AND GROWTH PACT JUSTIFY RETRENCHMENTS AND BURDEN INCREASES AS MASSIVE AS THE ACCUMULATED 23 BILLION EURO (EQUAL FOUR PERCENT OF GDP) ANNOUNCED IN THE DRAFT 2004 BUDGET. THEY CONSIDER THE COALITION'S RESPONSE TO CURRENT BUDGET PROBLEMS AS AN ILL TIMED AND OVERDRAWN REACTION. THE COUNCIL OF STATE HAS CRITICIZED THE COALITION'S PACKAGE OF SPENDING CUTS AND BURDEN INCREASES UNNECESSARILY MASSIVE, AND "PRO-CYCLICAL" IN A TIME OF RECESSION. BUDGET CUTS AND BURDEN INCREASES ARE LIKELY TO DAMPEN PUBLIC AND CONSUMER SPENDING AND HAVE A POTENTIAL OF SERVING AS A DRAG ON ECONOMIC RECOVERY FORECAST FOR 2004.

15. BANKING ECONOMISTS ARGUE THAT IN THE ABSENCE OF EXTRA MEASURES THE BUDGET WOULD MOVE INTO A DEFICIT OF 3.8 PERCENT OF GDP IN 2004, WHILE THE STRUCTURAL DEFICIT WOULD BE LIMITED TO ROUGHLY 2 PERCENT OF GDP. A CONSOLIDATION PACKAGE OF BUDGET CUTS AND BURDEN INCREASES OF ROUGHLY 2 PERCENT OF GDP WOULD HAVE BEEN SUFFICIENT TO ACHIEVE THE GOVERNMENT'S FISCAL CONSOLIDATION TARGETS. AND ALTHOUGH THE STRUCTURAL DEFICIT WOULD FALL SHORT OF THE SGP CRITERION OF "A NEAR BALANCED BUDGET" IN 2007, GIVING UP EXTRA BUDGET MEASURES WOULD ALLOW AUTOMATIC STABILISERS TO DAMPEN THE CYCLICAL DOWNTURN.

16. WITH REGARD TO THE TIMING OF VARIOUS BUDGET MEASURES, ECONOMISTS ARGUE THAT THE BULK OF SPENDING CUTS AND BURDEN INCREASES WILL BE IMPLEMENTED IN 2004 AND 2005 WHEN CYCLICAL CONDITIONS ARE STILL RELATIVELY FRAGILE. THE BALKENENDE II GOVERNMENT HAS COME UNDER GROWING PRESSURE TO POSTPONE PORTIONS OF ITS CONSOLIDATION PACKAGE UNTIL AFTER 2005. A MUCH USED ARGUMENT IS THAT EVEN WITHOUT THE PACKAGE OF EXTRA MEASURES, THE DEFICIT IN 2004 WOULD STILL BE NO MORE THAN ROUGHLY HALF A PERCENTAGE POINT ABOVE OF THE 3 PERCENT DEFICIT STANDARD. THE BALKENENDE II COALITION HAS ALSO BEEN URGED TO HOLD LESS TO THE STABILITY AND GROWTH PACT DOCTRINE AND TO GIVE HIGHER PRIORITY TO MEASURES AIMED AT STIMULATING LONG-TERM ECONOMIC GROWTH POTENTIAL.

GOVERNMENT FIRM ON LONG-TERM OBJECTIVES

17. THE GOVERNMENT HAS SUCCESSFULLY HELD TO ITS BUDGET OBJECTIVES ARGUING THAT THE RETRENCHMENTS ARE KEY TO LONG-TERM ECONOMIC STABILITY AND REFORM. ALLOWING EVEN LARGER DEFICITS, THE GOVERNMENT ARGUES, WOULD JEOPARDIZE IMPORTANT ECONOMIC GOALS SUCH AS REDUCING THE OVERALL DEBT BURDEN TO PROVIDE FOR THE NEEDS OF AN AGING POPULATION. THE GOVERNMENT ALSO ARGUES THAT PUBLIC SECTOR INFLUENCE ON CYCLICAL DEVELOPMENTS IN A RELATIVELY SMALL AND OPEN ECONOMY SUCH AS THE NETHERLANDS IS VERY SMALL. THROUGH THIS BUDGET, THE GOVERNMENT IS ALSO PROMOTING ITS PRIORITY SOCIAL OBJECTIVES - "A LANDSLIDE SHIFT IN CULTURAL MINDSET", ACCORDING TO PRIME MINISTER BALKENENDE - OF REDUCING THE ROLE OF GOVERNMENT AND REQUIRING MORE INDIVIDUAL RESPONSIBILITY.

18. THE GOVERNMENT HAS IDENTIFIED AS IMPORTANT POLICY OBJECTIVES TO BE PURSUED THROUGH THIS BUDGET IMPROVING THE SERIOUSLY ERODED PRICE COMPETITIVE POSITION OF THE DUTCH BUSINESS SECTOR, INCREASING THE DUTCH ECONOMIC GROWTH POTENTIAL, IMPROVING THE QUALITY OF PUBLIC SERVICES, AND MOVING THE BUDGET INTO NEAR BALANCE CONDITIONS BY 2007 AS BY FAR THE MOST IMPORTANT. TO MEET ITS POLICY TARGETS, THE COALITION HAS PLACED REDUCING LABOR COSTS, INCREASING LABOR

MARKET PARTICIPATION, BOOSTING PRODUCTIVITY THRU INNOVATION,
AND COPING WITH THE FINANCIAL IMPLICATIONS OF A RAPIDLY
AGING POPULATION PROMINENTLY ON ITS AGENDA. AS A NOVELTY IN
DUTCH POLITICS, THE CENTER-RIGHT COALITION AGREED TO
BENCHMARK ITS PERFORMANCE AGAINST MAJOR SOCIO-ECONOMIC
POLICY TARGETS AGREED IN THE 2003 COALITION AGREEMENT AND
THE DRAFT 2004 BUDGET. MAJOR POLICY TARGETS TO BE MET BY
2007 HAVE BEEN LISTED AS FOLLOWS.
0 ECONOMIC GROWTH TO EXCEED THE EU-15 AVERAGE GROWTH RATE
0 THE STRUCTURAL DEFICIT TO BE REDUCED TO 0.5 PERCENT OF
GDP
0 THE DUTCH COMPETITIVE POSITION TO BE IMPROVED
SIGNIFICANTLY
0 PUBLIC RED TAPE TO BE REDUCED BY 25 PERCENT TO ALLOW
FOR INCREASED PRIVATE INITIATIVE
0 THE EFFICIENCY OF DUTCH UTILITIES SECTORS (GAS, POWER,
POST AND TELECOM) TO RANK AMONG THE EU'S TOP-FIVE PERFORMERS
0 THE QUALITY OF DUTCH CORPORATE GOVERNANCE TO IMPROVE TO
MATCH THE INTERNATIONAL TOP

COMMENT

19. PASSAGE OF ITS TOUGH, UNPOPULAR--BUT IN THE EYES OF THE
COALITION PARTNERS NECESSARY--BUDGET THROUGH PARLIAMENT
AMOUNTED TO AN IMPORTANT POLITICAL AFFIRMATION OF GOVERNMENT
POLICY. UPCOMING NEGOTIATIONS BETWEEN THE GOVERNMENT,
INDUSTRY AND TRADE UNIONS ON CONTRACT WAGES AND PAY
CONDITIONS FOR 2004 AND 2005 WILL BE ANOTHER KEY TEST.
TRADE UNIONS HAVE ALREADY SIGNED THAT THEY REMAIN
SKEPTICAL OF THE SIGNIFICANT WAGE MODERATION THAT IS
IMPORTANT TO THE SUCCESS OF THE GOVERNMENT'S ECONOMIC
PROGRAM. THE GOVERNMENT UNDOUBTEDLY HOPES FOR A FASTER THAN
ANTICIPATED PICK UP IN WORLD ECONOMIC GROWTH THAT WILL
MITIGATE THE NEED FOR ADDITIONAL BIG SPENDING CUTS NEXT
YEAR. UNDER THESE CONDITIONS OF BUDGET AUSTERITY, WE
ANTICIPATE THAT THE DUTCH WILL BE RELUCTANT TO SPEND
SIGNIFICANT AMOUNTS OF NEW POLICY INITIATIVES AS THEY NEED
TO CUT BACK ON EXISTING ONES. (DRAFT:JERAZOUX-SCHULTZ).
SOBEL

SOBEL